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Statement of the Shadow Financial Regulatory Committee on
The Arms Race between Innovation and Regulation in Derivatives

Markets

February 10, 2014

To reduce the likelihood of future financial turmoil, regulatory authorities in the US, Europe, and other financial centers are crafting rules to push standardized over-the-counter (OTC) derivative products into centralized clearing organizations. Centralized clearing may enhance financial market stability by improving transparency, increasing and simplifying netting, and potentially improving margin requirements.

In the U.S., section 806 of the Dodd-Frank Act (DFA) opens the potential for exchange-traded clearinghouses and central clearing parties (CCP) to be designated as systemically important “financial market utilities” (FMUs) that in times of crisis could have access to Federal Reserve credit support. Financial utility designations extend the safety net and, absent adequate regulation and safeguards, create a new class of too-big-to-fail institutions. FMUs rechannel and concentrate important types of systemic risk. The problem is that FMUs may be tempted to use their “too-big-to fail” status to offer new products or reduced contracting safeguards to profit at taxpayer expense.

In July 2012, the U.S. Financial Stability Oversight Council (FSOC) designated eight domestic clearing corporations as FMUs. The DFA requires FMUs to be subject to enhanced prudential standards. These

standards, incorporated in Federal Reserve Board Regulation HH, are designed to comply with the Dodd-Frank Act and the Principles for Financial Market Infrastructure (PFMI) developed to implement G-20 recommendations.

How Is This System Affecting Derivatives Markets?

The Federal Reserve does not directly regulate or supervise derivatives trading. The primary regulators for derivatives markets are the CFTC and SEC. These agencies have been slowly crafting rules and guidance to promote transparency and minimize systemic risk. While different proposals are still being studied and reconciled, financial institutions have not stood still. They have been designing new products and adjusting their organizational forms and geographic footprints to take advantage of the likely carveouts, exemptions, and jurisdictional conflicts that differences in individual-country rules will entail. A particularly notable result has been an extension and blending of swaps, options, and futures product lines at traditional futures exchanges.

Innovations undertaken by the Chicago Mercantile Exchange (CME) exemplify this process. First, CME officials have expanded the use of portfolio-margining for clearing-member positions and seven members have so far signed up for their unfolding portfolio-margining program. Portfolio margining conserves member collateral, but is based on uncertain and possibly incorrect assumptions about the correlation of movements in the value of different contracts. Potential deviations from contract assumptions have safety-net implications that need to be examined. Even conservative assumptions about correlations are likely to fail in stressful conditions.

Second, the CME has also established a startup in London and partnered with foreign institutions as a way to expand in Europe without having to offer in its US venue the open access for settlement of contracts initiated on European exchanges as envisioned for EU Markets in the Financial Instruments Directive (MiFiD). As it grows, this network of cross-border connections threatens to generate new categories of hard-to-monitor systemic risk.

Third, the CME found ways to lower effective capital requirements by creating futures contracts to trade interest rate, currency, and credit swap risk. The reduction comes from the shorter settlement horizon used in margining futures contracts. During the last year, open interest for the CME's "Deliverable Swap Futures Contracts" has increased sharply. The novelty of these contracts is that they clear a traditional futures contract in established ways, but the deliverable is not one or another commodity, but a bilateral swap contract.

Fourth, a series of additional CME activities are migrating other risks from banks to the CME by trading innovative instruments that compete closely with products or services offered by banks and money-market funds. The CME now clears a number of "ultra-short-duration" exchange-traded bond funds (the timing of whose payoffs resembles those of a deposit) and "E-micro foreign exchange contracts" that are one-tenth the size of their standard foreign-exchange futures contract. The reduction in contract size expands opportunities for firms that operate across borders to initiate transactions outside the banking system. The CME has

introduced options on mid-yield-curve bonds and weekly settlement for selected contracts that have similar effects.

The Ongoing and Likely Migration of Systemic Risks is Undersupervised

Banking risk is likely to migrate to foreign derivatives clearing organizations as well. The DFA assigns supervision of securities-based swaps made by “US persons” to the Securities and Exchange Commission (SEC), but leaves supervision of trading in other swap and *all* futures contracts with the Commodity Futures Exchange Commission (CFTC). Neither of these agencies has the budget, expertise, or authority to monitor and mitigate the potential buildup of systemic risk occurring at nonbank financial market utilities under their aegis, let alone to supervise trades made on financial market utilities chartered in other countries. To address the problem of regulatory arbitrage, the CFTC has defined “US persons” broadly and insisted in principle on cross-border jurisdiction over swaps entered by US persons irrespective of where the trade might be executed. The agency’s stated goal is to see that swaps that US persons choose to execute abroad are not regulated any differently from those they execute in the US.

But things are not working out this way in practice. Pressure from foreign regulators persuaded the CFTC and SEC to write into their rules a poorly defined framework of “substituted compliance.” Substituted compliance means that foreign affiliates of US firms booking deals abroad would be regulated by the country in which they are domiciled as long as the country enforced rules sufficiently comparable to those of the US. In its June, 2013 proposed Final Guidance (CFTC Press Release PR6293-12), the CFTC defined comparability in terms of “rules comparable and comprehensive to relevant Dodd-Frank requirements.”

Since many rules in Europe and Asia have not yet been finalized, this definition sets a criterion that simply cannot be met at this time. Nevertheless, on December 20, 2013, the CFTC granted substituted compliance to regulatory authorities in six foreign jurisdictions: the EU, Australia, Canada, Hong Kong, Japan, and Switzerland. In a joint statement, the Commissioners declared (with one dissent) that they had “reviewed each regulatory provision of the foreign jurisdictions submitted to us and compared the provision’s *intended outcomes* to the Commission’s own regulatory objectives.”

The Shadow Financial Regulatory Committee believes that focusing on the similarity of stated intentions is a superficial and dangerous standard. Because the road to stressful outcomes is almost always paved with good intentions and regulation-induced innovation, substituted compliance should not be granted so easily. What is needed is careful and ongoing analysis of the likelihood and extent of unanticipated consequences that might flow from substantive differences in the way individual countries design and operate their regulatory frameworks.

Constraining the risks these firms take must be an explicit goal of CFTC, SEC, Federal Reserve and foreign rulemaking. The more successful bank-like and other new products become at the CME and counterpart FMUs, the more they will solidify their designation as “financial market utilities” and be able to exploit more reliably the implicit guarantee

embodied in the access to the Federal Reserve credit support they receive from Section 806 of the Dodd-Frank Act.

Currently neither the SEC nor the CFTC staffs have enough economic and financial expertise to carry out such analysis. To implement the heightened supervision FMUs require, the Shadow Financial Regulatory Committee believes that the SEC and the CFTC require a new mission statement and expanded staff and budget.